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PRINCIPAL AND SURETY—APPLICATION OF PAYMENTS BY CREDITOR
WHEN SOURCE OF FUNDS IS KNOWN—X, contractor on a housing project,
sublet the painting work to Y. Y purchased paints from Z and also borrowed
money from Z to pay his laborers until payments began to come in. Pursuant
to an agreement between $Y$ and $Z$, $Y$ turned over checks received from $X$ to $Z$, and these checks were applied against the debt owing for the money loaned to $Y$ by $Z$. $Z$, as materialman and as beneficiary of an ordinary bond to pay labor and materials, sued $X$ and the surety on the bond. **Held,** $Z$ was a mere volunteer in advancing money for $Y$’s laborers, and, knowing where the checks came from, he should have applied the checks against the debt for the materials furnished. *United States for Use of Carroll v. Beck,* (C.C.A. 6th, 1945) 151 F. (2d) 964.

It is generally held that when there is more than one debt owed by a debtor to a creditor, the creditor can apply payments from the debtor to whichever debt he wishes. However, this freedom of application is subject to some well-established limitations, one of which is that where the interests of others are affected and the creditor knows where the money comes from, the creditor must apply the money in a manner consistent with those interests the reasons often given for this limitation, which is the rule in a majority of American jurisdictions, are that it is based on considerations of equity and justice and that there is an implied contractual obligation to the surety and his principal. This limitation is not applied by all courts, however, and the courts which refuse to apply it take the view that the money received by the creditor, in the absence of application by the debtor, is his own, and he can use it as his own. These courts also point out that it would be illogical to hold that the creditor could dispose of the money to pay off prior debts to anyone but a materialman even though those persons knew the source of that money and yet hold that a “trust” existed if the debtor paid a prior debt to a materialman and the materialman knew the source of the funds with which he was paid. While both views are reasonable, it would seem that the majority rule which recognizes the equities of the third person has much merit in the usual case where the money is applied to an antecedent debt having no relation to the contract in which a surety or principal debtor is an interested party, but where there is a fact situation similar to that in the principal case, fairer results would be accomplished by applying the minority view than by an application of the so-called equitable view. Since this latter view was intended to do justice to the parties involved, the court should look at all the facts and arrive at an equitable result rather than follow a rule stated in general terms, which has evolved from particular fact situations and which might be inapplicable to the case at hand. In the principal case there was good reason for a holding in favor of the creditor. The funds which he applied were used to extinguish debts arising from loans made to the debtor to pay labor costs on the building project—an expense the debtor would have had to meet in any case, and if the debtor had paid the laborers directly, the over-all situation would have

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1 40 Am. Jur., Payment, § 117, and cases there cited.
2 40 Am. Jur., Payment, §§ 119-123.
3 40 Am. Jur., Payment, § 123.
4 41 A.L.R. 1297 (1926).
5 Principal case at 966.
7 41 A.L.R. 1297 (1926), and cases there cited.
8 Standard Oil Co. v. Day, 161 Minn. 281, 201 N.W. 410 (1924).
been the same, with the important exception that the creditor would have succeeded in an action to recover for his materials. Because of the view taken of such a case in the federal and other courts following the majority rule, it would be advisable for a creditor to protect himself in a fact situation similar to that in the principal case by taking an assignment of the laborers’ claims and using such an assignment as a basis for recovery. The only other alternative would be for the courts which apply the “equitable” rule to examine the fact situation before them to determine whether equity is actually being done.

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